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General Business Conditions

THE action of the President in calling Congress into session November 17 to consider the problems of foreign aid and domestic inflation sets the stage for decisions which will greatly influence American business. Declaring that "our own domestic prosperity is endangered by hunger and cold in other lands," the President states that prompt action by Congress is essential. "The need is too pressing — the results of delay too grave," he warns, "for Congressional action to wait until the next regular session in January."

"It is," the President says, "urgently necessary for the Congress to take legislative action designed to put an end to the continued rise in prices, which is causing hardship to millions of American families and endangering the prosperity and welfare of the entire nation." At the same time, "it is also necessary to take adequate steps to meet the crisis in Western Europe, where certain countries have exhausted their financial resources and are unable to purchase the food and fuel which are essential if their people are to survive the coming Winter."

Thus, by word and by action, the President has recognized the dual nature of the problem. Reviewing the various forces at work, he emphasizes our greatly expanded domestic demand. Pointing out that "the average buying power of our people today is 40 per cent higher than it was in 1929," he asserts that "the major cause of high prices in this country is the great demand among our own people for available goods." In view of the constant pressure of these demands, the President calls anew for public support of the voluntary food-saving program, pointing out rightly that "dollars appropriated by the Congress cannot feed hungry people if there is no food for the dollars to buy."

The President in his statement did not enumerate what his specific proposals would be, but said that when Congress meets he would recommend a program for dealing with inflation, high prices, and the high cost of living. He added that, "Adequate measures — enacted in time — are necessary to correct the present situation."

This move by the President makes pertinent some brief review of what has been happening in the commodity markets, as well as some consideration of underlying influences and the kind of action that might be appropriate.

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The Rise in Commodity Prices

Led by foodstuffs, commodity prices have moved into new high ground during the past month, going through the previous peaks established last Spring. Since the short corn crop became a price factor last Summer, the twelve foodstuffs included in the Bureau of Labor Statistics sensitive wholesale price index have risen 15 per cent, while the sixteen industrial raw materials have risen 8 per cent. During the same period, the Bureau's much more inclusive index

of 900 commodities increased 4 per cent. This index at the end of October was 40 per cent higher than on June 30, 1946 when price controls first were abandoned, and a little more than double the price level at the outbreak of war in August 1939.

The table below gives a comparison of current prices of individual commodities with those of World War I; also with the price levels in August 1939, and those fixed just before the end of price control on June 30, 1946.

SPOT COMMODITY PRICES

Commodities	Unit	World War I: July 1914	World War I: War or Post-War Peak	World War II: August 1939	World War II: June '46 OPA Ceiling	Oct. '47 High
Agricultural						
Cocoa	lb.	11.38c	23.50c	4.47c	8.99c	53.50c
Coffee	lb.	11.94c	23.44c	6.40c	15.45c	28.00c
Corn	bu.	$ 0.71	$ 2.36	$ .55	$1.46	$ 2.52
Cot'ns'd Oil	lb.	6.40c	27.50c	4.62c	12.65c	23.50c
Hogs	lb.	8.77c	22.39c	6.36c	14.85c	29.60c
Lard	lb.	9.57c	34.68c	6.75c	13.80c	24.35c
Rice	lb.	3.78c	9.44c	3.00c	6.60c	12.25c
Steers	lb.	9.68c	19.84c	9.12c	18.00c	30.50c
Sugar	lb.	3.28c	20.90c	2.03c	4.10½c	5.50c
Wheat	bu.	$ .82	$ 3.50	$ .68	$1.97	$ 3.15
Industrial						
Copper	lb.	13.49c	36.00c	10.50c	14.38c	21.50c
Cotton	lb.	13.13c	42.30c	8.76c	*30.97c	32.91c
Hides	lb.	19.25c	52.00c	11.00c	15.50c	37.25c
Lead	lb.	3.89c	12.25c	5.05c	8.25c	15.00c
Steel Scrap	ton	$11.75	$40.75	$16.25	$20.00	$43.00
Tin	lb.	31.75c	$ 1.10	49.50c	52.00c	80.00c
Zinc	lb.	4.84c	27.50c	4.75c	8.25c	10.50c
Rubber	lb.	60.00c	99.50c	16.62c	22.50c	23.00c

*No ceiling on cotton.

It will be noted that hogs, corn, cattle, rice, cocoa, and coffee all sold last month much higher than the World War I peaks, with wheat not far below. On the other hand, the non-ferrous metals, while having risen sharply since price controls were removed last year, still are well below World War I peaks as are also hides and rubber. Steel scrap and lead are among the few major industrial raw materials currently selling above World War I peaks. Alone among the agricultural commodities in the table, sugar still is selling substantially below World War I peaks. Towards the end of October prices of grains and livestock dropped somewhat below the month's highs.

Causes of High Prices

The latest rise in food prices has been spearheaded by the grains, and by the fats and oil, under the twin influences of large Government purchases to meet export commitments, and continued heavy consumption at home. There is general agreement as to record high incomes at home being the basic cause of the high prices for many foodstuffs, particularly the meats, dairy and poultry products in which consumption moves rather flexibly with purchasing power. Per capita meat consumption this year will run close to 156 lbs., or about 25 per cent above the prewar average of 125 lbs. Likewise, per capita consumption of eggs, poultry and dairy products in 1947 will be around 27 per cent, 36 per cent, and 7 per cent larger, respectively, than the 1935-39 average.

A second cause which is commonly pointed out is the export demand. In most cases the expansion of export demand has been a minor factor as compared with domestic consumption. Exports of meats, poultry, and dairy products, for example, are running this year at less than 5 per cent of production. In wheat, however, where domestic milling rquirements are rather rigid, and where the recent price rise has been greatest, the huge export demand clearly has been the primary cause of the upward price pressure. This year's goal to export a record 500 million bushels of wheat represents about 35 per cent of the record 1947 crop, while last season's exports of 400 million constituted 45 per cent of the smaller 1946 crop. During the preceding two decades our wheat exports had averaged about 11 per cent of total wheat crops grown.

Strong evidence that export demand, rather than speculation as has been charged, is the chief price raising factor in the wheat market was furnished last month by the imposition of much higher margin requirements by the grain exchanges. While having an immediate effect in sharply curtailing trading volume, the new margins had no effect whatsoever in keeping down prices. In fact, after the higher margins were invoked, cash wheat continued to rise by another 40 cents a bushel to a new peak of $3.15 At about the same time, extremely heavy purchases were resumed by the Commodity Credit Corporation and during the four week period ended October 24, it acquired about 58 million bushels of wheat in the open market, as well as smaller amounts of flour. This was in addition to trade purchases to fulfill private export commitments. These four week purchases were more than the United States exported in all but two years of the past decade.

A third factor sparking the rise in wheat prices has been the threat of a short Winter wheat crop next year. Drought in the main producing belt in the Southwest has continued to hamper seeding operations and with the optimum planting dates already past, farmers probably will not be able to get in their full acreage goals. Furthermore, sub-soil moisture reserves, so important to Winter wheat, are deficient in this area. Without soaking rains before freeze-up time, per acre yields next Summer are quite likely to be below average, thus reducing the supply available to meet the world's urgent requirements.

Still a fourth factor in the price situation has been the price pegging operations of the Government itself. Under legislation passed during the war, the Commodity Credit Corporation currently is supporting market prices of certain farm products at 90 per cent of parity through loans and purchases, and is obligated to continue this program through 1948. Through these operations the C.C.C. in recent months has taken off the markets substantial quantities of eggs, dried milk, potatoes, turkeys, peanuts, and even grains. Just within the past month it has become a heavy buyer of raisins and prunes although these commodities are not specified in the price support legislation.

Although most commodities are selling above the support prices, nevertheless the fact that a floor has been placed under prices encourages farmers to hold and buyers to take long speculative positions. Towards the end of October, the C.C.C. announced that its large holdings of frozen eggs would not be sold until prices rose to still higher levels, while its even larger holdings of dried eggs would be shipped abroad.

What To Do?

The whole question of government procurement is, of course, one of the very important factors in the grain markets, and the method and speed with which the Government buys will influence the pressure on prices. The Department of Agriculture estimates that the trade and government purchases made to date have more than 60 per cent covered the 570 million export goal, including 70 million feed grains, leaving only about one-third to be purchased during the final two-thirds of the season.

A measure now being considered to induce a freer movement of wheat from the farms would be offering the farmer partial payment and a receipt for wheat delivered now while leaving him free to complete the sale at market quotations during the early part of 1948.

A further effort on the side of limiting demand is being made under the program launched during the past month by the Citizens' Food Committee, headed by Mr. Charles Luckman as chairman. The distilling industry has agreed to a 60-day shutdown which began late in October; the brewing industry has voluntarily stopped using wheat and rice altogether and has curtailed its corn consumption 25 per cent; and the baking industry is cooperating. The public has been asked to make its contribution by foregoing meat on Tuesdays, and eggs and poultry on Thursdays, with the purpose of indirectly cutting down on grain fed to livestock.

The grain savings made by the direct conservation measures adopted so far are calculated at around 35 million bushels. However, in order to safeguard the 570 million export goal, the grain conservation goal has been set at 100 million, to be reached by the end of the year. The most important savings will have to be made at the farm level. What is needed here is a culling of flocks and herds to reduce the number of inefficient milk and egg producing animals that are eating grain. The second point is to reduce the amount of grain fed to meat animals, marketing them at lower weights and less finish.

Fortunately, the high price of grain naturally has these effects, stimulating culling and making feeding less profitable. The price premium of wheat over corn has widened to about twice its usual spread. As a result, the feeding of wheat to livestock during the first quarter of the wheat crop-year (July 1-Sept. 30) was actually somewhat smaller than during the same period last season although, because of the short corn crop, a considerable increase had been expected. Whereas the Cabinet Food Committee had estimated that 350 million bushels might be fed this season, the first quarter rate if projected for the full year would total only 175 million bushels. This saving alone would solve the entire wheat problem. However, it is unsafe to place too much reliance on one quarter's experience.

At the same time that consumption is being reduced by allowing prices to reflect the real scarcity, farmers are stimulated to efforts to expand production. As a last resort they are even planting Winter wheat in dry soil. By contrast, in Argentina where the farm price has been held down to less than one-third the export price received by the Government, the wheat acreage for the crop to be harvested in December has been cut 17 per cent to the lowest on record. Similarly, in Western Europe bread grain acreage has been held down by price ceilings, and the farmer has found it more profitable to grow barley and oats to feed to livestock which can either be held as a hedge against inflation or sold for meat in the black market.

Finally, in any program to be laid before a Congress called to deal with high prices, the question of what the Government itself is doing to boost prices and the cost of living must surely occupy an important place. There is clearly a need for a thorough-going review of the whole field of price support legislation, with the view to restoring a larger measure of competition in foodstuffs for the consumer's dollar. With farm prices left free to move on the up-side, consumers

at the very least should be allowed to buy on the down-side without the Government stepping in as a competitor and holding foodstuffs off the market for higher prices.

The Overall Problem of Inflation

The problem, however, is much broader than can be dealt with along the foregoing lines alone. The major cause of high prices in this country is, as the President pointed out, the great demand among our own people for available goods. Efforts to control the situation must attack the problem at this point.

This means, first, that Government at all levels ought to be cutting its enormously expanded expenditures. The staggering $37 billion federal expenditure budget, and growing outlays by States and municipalities, are large contributors to the pressure on prices. This is a time when by *any* theory of the business cycle public works programs should be radically curtailed. Yet they threaten to soar to the highest peaks ever. The cash bonus payments to war veterans, putting cash in people's hands without corresponding current production, again adds to the tide of inflationary pressure.

Second, business programs for capital expenditures on new and expanded plant and equipment ought to be carefully reviewed. Many of these projects will, of course, have to be carried forward; some have already been postponed due to prohibitive costs; others can be and ought to be deferred, both in the general interest and to avoid loading the enterprises with expensive facilities that may not pay out.

Third, this is a time to emphasize individual saving rather than spending. In the case of housing, for example, despite the shortage and even discomfort in living conditions, it may be wise to postpone new building in instances where going ahead at present costs would mean the assumption of excessive financial commitments.

In short, it is only by tackling the basic cause of the disorder in the economy the President himself recognizes, which is too many people trying to spend too much, that any real progress can be made in finding a remedy. It is safe to predict this will prove a hard nut to crack and it will call for great understanding and willingness to subordinate selfish considerations for longer-term objectives.

Third Quarter Earnings

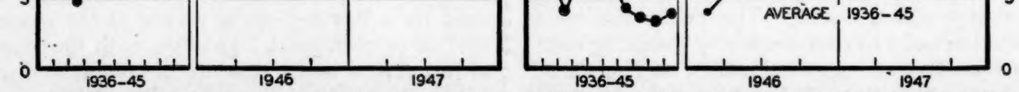
Corporate reports issued during the past month reflect the record high levels of production, trade, and national income that continued during the third quarter. However, while net earnings generally were maintained at historically high levels, the trend, which in 1946 was rising sharply with expanding business volume to a peak in the fourth quarter, has since evened off as a result of increasing competition and rising costs.

Tabulation of the reports published to date by 375 leading corporations in the manufacturing, mining, trade, and service industries shows earnings in the first three quarters of 1947 slightly below the fourth quarter of 1946. This trend is indicated by the following table giving dollar totals, and by the chart at the bottom of the page giving the comparison in terms of return on net worth and profit margin on sales for a somewhat larger group of manufacturing companies.

Net Income After Taxes of 375 Manufacturing, Mining, Trade, and Service Corporations

1946	March Quarter	$212,746,000
	June "	414,687,000
	September "	494,723,000
	December "	674,670,000
1947	March "	654,547,000
	June "	671,598,000
	September "	658,092,000

Although the composite of earnings in the third quarter of 1947 was above the third quarter of 1946, more than one-third of the companies reported declines.



Average Annual Rate of Return on Net Worth, and Average Net Profit Margin on Sales, of Leading Manufacturing Corporations. (Quarterly figures for 1946-47 based upon 400 manufacturing corporations, with third quarter of 1947 preliminary. Annual figures for 1936-45 based upon our tabulations of annual reports covering a much larger number of manufacturing corporations.)

For the first nine months of 1947, combined net income of the group totals $1,984,000,000 and still shows a substantial increase over the corresponding period of 1946, amounting to 77 per cent. This increase, however, as the quarterly figures clearly bring out, was not due to a continuing rise in 1947. It was caused by the fact that earnings in the first half of 1946 were severely curtailed as large segments of industry—particularly steel, automobiles, and heavy equipment—were virtually closed down by strikes, plant reconversion, and material shortages, and many of the country's leading manufacturing organizations operated at heavy deficits.

Capital and surplus of the group at the beginning of 1947 aggregated $16.3 billion, upon which the nine months' net income represented an annual rate of 16.2 per cent, compared with a net worth in 1946 of $15.0 billion and a return of 10.0 per cent. Our summary by certain major industrial groups, based upon reports available at this time, is given in the table below.

Of the quarterly earnings totals given for fifteen groups, it will be seen that three groups (petroleum refining, automobiles and parts, and mining and quarrying) were at their peak in the third quarter of 1947. The other twelve groups reached their peaks in the last half of 1946 or the first half of 1947, and the subsequent declines have in some cases been considerable.

Many retail and wholesale trade lines have experienced a sharp drop in earnings this year. Although dollar sales are still in most cases showing gains over last year, much of the gain is due merely to higher prices. High food prices have hurt sales of other goods, while heavier markdowns have been required to move substandard nerchandise, and operating costs have continued to advance.

Trend of Profit Margins

In the manufacturing industries, the tremendous expansion in sales volume over that of early 1946 was a major factor in the sharp rise of net income and of return on net worth. Profit margins per sales dollar, as shown by the diagram on the preceding page, also rose to substantially above a long-term average, including the war period when most of the manufacturing industries operated almost exclusively on war contracts or other essential goods, and profits were held down by a combination of controls, including allocation of manpower and materials, ceilings on prices and wages, fixed-fee contracts, renegotiation, and excess profits taxes.

Present margins, however, are little if any wider than in other years of active business such as 1936-37 or 1940-41. For the third quarter, the average rate of around 7.2 cents per sales dollar indicated by preliminary figures compares with a ten-year average 1936-45 of 5.5 cents, and is the same as the average for the four years 1936-37 and 1940-41.

The figures shown in the chart both for return on net worth and profit margin on sales are based upon 400 of the largest manufacturing corporations in the U. S. whose quarterly sales and net income are published in their interim shareholders' reports or made available through the Securities & Exchange Commission. This broad group of leading companies representing prac-

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST NINE MONTHS

Net Income is Shown as Reported — After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. Annual Rate of Return for Nine Months is Computed on Net Worth, Which Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Net Income by Quarters 3 Qr. 1946	4 Qr. 1946	1 Qr. 1947	2 Qr. 1947	3 Qr. 1947	Net Income Nine Months 1946	1947	% Annual Return Nine Months 1946	1947
27	Food products	$ 32,826	$ 53,231	$ 45,808	$ 35,691	$ 36,643	$ 86,877	$ 118,142	15.7	19.8
27	Textiles and apparel	27,850	38,170	30,143	31,137	30,074	74,089	91,354	25.4	25.5
18	Pulp and paper products	10.931	13,585	21,772	23,004	21,402	28,185	66,178	13.1	24.6
36	Chemicals, drugs, etc.	71,287	87,442	91,000	88,301	84,010	214,819	263,311	15.2	17.0
16	Petroleum products	76,468	86,389	81,132	114,045	115,320	191,241	310,497	10.1	15.4
15	Cement, glass, and stone	19,960	22,970	24,789	28,945	25,426	45,730	79,160	11.8	17.9
29	Iron and steel	81,051	85,503	111,502	87,955	84,282	156,365	283,739	6.2	11.0
12	Electrical equip. and radio	16,571	60,170	38,416	42,773	39,772	17,705	120,961	2,8	17.7
26	Machinery	10,206	11,993	10,461	16,643	14,651	22,866	41,755	7.6	12.0
21	Autos and parts	40,026	83,411	80,177	86,223	88,764	19,370	255,164	1.6	20.0
57	Other metal products	41,306	55,807	52,987	49,823	51,890	90,991	154,700	11.4	17.4
31	Miscellaneous mfg.	24,525	31,793	30,081	26,150	22,241	63,831	78,472	19.9	20.8
315	Total manufacturing	453,007	630,464	618,268	630,690	614,475	1,012,069	1,863,433	9.6	16.4
27	Mining and quarrying	18,545*	20,677*	21,007*	23,355*	25,090*	44,499*	69,452*	10.4	15.6
22	Trade (retail and whol.)	19,307	18,402	11,305	12,914	14,020	54,356	38,239	22.2	13.9
11	Service industries	3,864	5,127	3,967	4,639	4,507	11,232	13,113	10.7	11.7
375	Total	$494,723	$674,670	$654,547	$671,598	$658,092	$1,122,156	$1,984,237	10.0	16.2

*Before depletion charges in some cases.

tically every major branch of industry has a total net worth of over $21 billion, and had total sales and other revenues of over $42 billion in the twelve months ended June 1947. It is estimated, on the basis of sales volume last year, that this group provides over one-fourth of the total employment and payrolls in the manufacturing industries.

This showing for profit margins, of course, differs widely from industry to industry. These differences and the changes during 1946 and the first half of 1947 are illustrated in the accompanying table covering the 400 manufacturing companies, plus 40 companies engaged in various branches of retail and wholesale trade.

Quarterly Net Profit Margins in Cents Per Sales Dollar of 400 Leading Manufacturing Corporations and 40 Trade Corporations

No of Cos.	Manufacturing	1946 1 Qr.	1946 2 Qr.	1946 3 Qr.	1946 4 Qr.	1947 1 Qr.	1947 2 Qr.
26	Food products	4.9	5.8	6.4	7.6	6.8	4.9
15	Beverages	7.0	7.7	8.6	9.2	7.1	6.2
27	Textile products	8.8	10.0	10.3	11.6	10.0	10.0
22	Pulp, paper prod.	6.8	8.5	9.6	10.6	12.3	12.6
26	Chemical products	9.5	10.1	10.1	9.5	10.7	10.0
12	Drugs, soap, etc.	10.3	10.1	10.4	9.5	7.9	6.8
16	Petroleum products	8.9	9.7	10.1	11.0	10.4	12.8
16	Cement, glass, stone	6.2	9.9	9.7	10.3	10.4	10.7
32	Iron & steel	2.1	5.7	6.8	6.5	8.0	5.9
10	Building equipment	3.2	6.5	7.5	12.3	9.1	7.5
18	Electrical eq. & radio	–12.7	8.8	3.4	9.6	6.3	6.4
10	Household equipment	5.8	9.0	9.8	8.9	9.2	8.8
29	Machinery	1.3	4.7	5.2	5.6	5.0	6.7
12	Nonferrous metals	–0.8	3.7	9.0	7.4	8.1	7.0
10	Office equipment	7.3	9.1	9.4	10.9	10.3	11.9
24	Other metal prod.	1.5	6.5	6.8	9.3	8.2	7.5
13	Autos & trucks	–9.6	2.8	4.3	7.6	7.0	6.2
32	Automobile parts	–1.4	3.1	5.6	5.5	5.8	6.4
9	Railway equipment	1.7	6.4	7.5	6.6	7.0	6.7
8	Aircraft & parts	1.5	5.5	0.4	–9.8	–0.5	0.6
33	Misc, mfg.	5.6	5.6	6.0	6.2	6.2	5.4
400	Total mfg.	4.1	6.9	7.4	8.3	8.1	7.6
	Trade						
40	Trade (ret. & whol.)	4.8	8.9	4.7	8.8	3.1	2.2

Are Profits Too High?

The current figures on corporate profits continue to be a subject of active – at times even bitter – controversy, with criticism ranging all the way from intemperate charges of "extortion" and "robbery" to milder suggestions that business is "making too much money", and ought in the general interest either to cut prices or to raise wages and so help to sustain consumer purchasing power. Among the various pronouncements that have appeared on this matter recently is the following quotation from an address last month by Secretary of Labor Schwellenbach before the American Federation of Labor convention at San Francisco. Discussing the general price rise than has occurred, and referring to the factor of business profits, he said:

> There is another factor which has been, let us conservatively say, submerged so far as the public presentation of the problem is concerned. That is the factor of profits. I accept fully the contention that any manufacturer or any corporation is entitled to make profits. The profit motive is the basis of our whole economy. I would no more favor a general regulation of profits than I would a compulsory arbitration of labor disputes. I also recognize fully the right and need of any corporation to set aside a portion of the profits for future use. Good management demands it.
>
> I do contend, however, that to the extent that profits result in price increases they cannot be defended in this particular period of our national economy. Corporation managers say quite properly that they must set up reserves against the day when they might be subject to losses. What I do object to is that many of the same people who contend for that right – to make their corporations secure – also contend that the wage earners of America should dip into their savings and let their personal futures take care of themselves. I think the wage earner is as much entitled to get a nestegg of insurance for the future as is a corporation. It is a proved fact that savings by wage earners decreased 45 per cent as between 1945 and 1946. It is a proved fact that the present savings of the great mass of the American people are 30 per cent below what they were on V-J Day.
>
> I am frank to confess that I don't know, and I don't believe anybody can lay down rules as to just what profits a corporation should make and how much it should retain for reserves. But I do know that for the first quarter of 1947 the profits of corporations were $857,000,000 compared with $323,000,000 for the same period a year ago. Corporations manufacturing automobiles earned almost half as much for the first quarter of 1947 as they did for the entire year 1939.

The foregoing statement by the Secretary is couched in moderate and restrained terms, and the questions raised are ones that a great many people are wondering about.

The Secretary evidently is fully aware of the need for reasonable earnings and of the importance of setting up reserves against future losses on inventories and other contingencies. The sole question is one of how much. He lays down the dictum that any profits that result in price increases are, ipso facto, excessive under present conditions; and cites figures to show that while wage earners' savings have been severely curtailed, earnings of corporations have expanded enormously. Yet, with all this, he nevertheless frankly acknowledges that "I don't know, and I don't believe anybody can lay down rules as to just what profits a corporation should make and how much it should retain for reserves."

Profits and Workers' Savings

As to the point about wage earners' savings, it will certainly be agreed that the wage earner has as much right as management to wish and to strive to set aside reserves for a "rainy day." The question, however, of who gets what out of corporate earnings is a matter for mutual agreement and bargaining between the management and workers of the individual industries concerned. We know of no way of laying down hard and fast rules for determining just how much workers shall earn and save, any more

than of laying down similar rules for corporations.

As to the significance of the savings decline cited by the Secretary, it should be borne in mind that the rate of savings during wartime was abnormally high, due to the great increase in income payments, to the shortage of consumer goods upon which income could be spent, and to the patriotic appeal to save and invest in war bonds. Today workers' incomes are higher than ever before, their savings are still large.

The profit comparisons used by Secretary Schwellenbach are unfortunate in that the period selected – the first quarter of 1947 with the first quarter of 1946 – involves a comparison with a period when earnings were severely curtailed as shown by our tables and chart given in the preceding article.

Profits Not All That They Seem

The main point to be made, however, is that the profits themselves are not all that they seem. In the first place, they contain or reflect a substantial measure of inventory profit, which represents a highly illusory gain that can be quickly changed to a loss when prices turn down. According to the Department of Commerce new national income figures, the factor of inventory profits amounted to $4.7 billion or 38 per cent of the estimated total corporate net income in 1946. Whereas the total corporate profits of $12.2 billion in 1946 were widely publicized as the largest on record, if allowance is made for these inventory adjustments the Department of Commerce figures show that the net income from operations was actually lower than in 1945.

Second, there is real question as to the extent to which earnings as currently reported are being overstated because of the fact that depreciation charges are commonly based upon original costs of plant and equipment and thus are wholly inadequate in view of the present level of replacement costs. While some companies have attempted to adjust for this situation by special reserves of one kind or another, this involves complicated accounting and tax questions, which are now being studied by a special committee of the American Institute of Accountants. Treasury Department regulations require that depreciation charges claimed as deductions for tax returns must be based upon original costs.

A recent study by the Machinery & Allied Products Institute of Chicago sets forth several possible ways of dealing with the problem and concludes that: "Since capital investment must be recovered in real purchasing power, not simply in dollars, under-depreciation should be recognized for managerial purposes whether recognized for tax purposes or not." Unless this is done, corporations may be misleading themselves, their shareholders, and the public as to their real earnings.

A sidelight on this question as to whether profits are "too high" is provided by the rapid expansion of bank loans since the end of the war, indicating that for a great many companies the supposedly high earnings are not in the form of available cash but have already been more than absorbed by the increased capital requirements of the business in a period of rising prices. These include both the higher dollar inventories and the resulting larger accounts receivable, and the capital invested in higher-cost plant and machinery for reconversion, modernization, and development.

On the latter point, it is to be noted that the steel companies are being called upon to further expand their capacity, and the United States Steel Corporation alone, in its recent quarterly report, announced a program of expending $500,000,000 for this purpose. The same necessities of keeping pace with the growing needs of the American people are facing the petroleum and numerous other industries, including electric light and power, telephones, and railroads.

Profits and National Income

All of this brings us back to what Secretary Schwellenbach said as to the impossibility of knowing just what profits corporations should make and how much they should retain for reserves. The problem is a difficult one, and there are many considerations. In concluding, it seems pertinent to refer to a report entitled "Data on Wages and Profits" prepared early this year by a group of government economists in the Legislative Reference Service, Library of Congress, for the Committee on Labor and Public Welfare of the United States Senate. Pointing out that corporate profits are a resultant of a particular volume of business and of national income levels, the report states:

> We do not pass judgment on whether net corporate profits (in 1946) of $12,000,000,000 are too high on the basis of a national income of $165,000,000,000 even when a fourth to possibly a third of the profits was the result of a favorable tax situation. It is, however, an historical fact that the proportion of the national income going to net corporate profits is lower than in many other periods of high-level production and reasonably full employment.

The real question about whether profits are too high or too low is not a moral question. After all, a corporation is not, except in very limited measure, a group of individuals to whom its gains or losses are personal. The main question

is rather the broad economic one of the relation between corporate earnings and the capacity of these enterprises to serve the needs of the country in the way that they must if civilization is to make progress.

Corporations are the principal mechanisms by which the inventions of the scientists and the technicians are turned into the goods and services which have raised the standard of living of our people to the highest level in history. The new discoveries of science, in recent years, together with the greatly increased cost of doing business and turning these inventions into usable goods and services, call for a lot of new money. The principal source of this money is corporation profits.

Corporations can, it is true, borrow substantial sums from the banks and from the market, but they will go broke if they borrow too much in relation to their net worth.

This point of view needs to be considered in judging today's profits.

Rise in Bond Yields

Responding to the continuing heavy demands for new long-term capital, more especially on the part of public utility companies and State and local governments, a pronounced reaction developed in the high-grade investment security market during October. Many of the major long-term bond offerings distributed earlier in the year fell to discounts of two to four points below the prices at which they had been originally sold. The 3 per cent twenty-five year debenture bonds of the International Bank, which had gone as high as 103 in July during their period of initial distribution, were traded at 99. An issue of $75,000,000 Pacific Gas and Electric Company 2⅞ per cent first and refunding mortgage bonds of 1980, offered at par on October 5, encountered a market disposed to await still higher yields with the result that the bonds sold down to 98, equivalent to a yield basis of near 3 per cent, before distribution could be carried through.

In the market for long-term obligations of States and municipalities, undistributed securities backed up in dealers' inventories temporarily as the absorption by investors fell short of the new supply coming onto the market. Long-term Treasury bonds showed a sympathetic decline during the second half of the month as some investors switched out of Governments in order to buy the new corporate offerings. The widest drop in Treasuries, however, was limited to about 1¼ points for the month as a whole, and all issues still commanded sizeable premiums over original offering prices. The restricted 2½ per cent bonds sold in the Victory Loan drive, for example, declined from 102 13/16 on September 30 to 101 9/16 a month later.

The question-mark as to where a new level of stability would be found for new issues of higher-grade corporate obligations appeared to be answered at least tentatively by the favorable reception given to $100,000,000 Pacific Telephone and Telegraph Company 3⅛ per cent bonds of 1987, priced to yield 3.07 per cent, on October 21. The return was a full quarter per cent better than had been offered on telephone financing only two or three months before. The bonds went to a premium of a point or more and the tone of the entire corporate bond market improved. It is felt in investment circles that rates around 3 per cent — compared with the former range of 2⅝ to 2¾ per cent — will reach new strata of investment funds, previously immobilized or awaiting more attractive returns before being committed for long periods of years. At the same time, while the era of large-scale refundings to take advantage of excessively cheap money rates is clearly at an end, it seems hardly possible that many worthwhile projects of capital expenditures will be deterred by the necessity of paying 3 per cent on money raised to finance them. More important considerations will be the earnings prospects of the borrower and the cost and availability of equipment, materials, and labor.

Rise in Yields on Municipal Bonds

In the longer perspective, the yields available on the purchase of long-term securities in the open market, excepting U. S. Government securities, have now recovered to the highest levels in several years. As the accompanying chart brings out, high grade municipal issues are now offering the most attractive yields since 1943. On these issues, which are wholly exempt from income taxes, prices fell, with resultant increases in yields, toward the end of 1945 when the corporation excess profits tax was repealed. After an intervening recovery to all-time highs in the Spring of 1946, they dropped again a year ago when the prospective market supply was increased by authorizations of bond issues by a number of States to pay bonuses to war veterans. The most recent drop dates back to September, when new offerings were accelerated for construction projects held back by the war. It is evident that, while banks provide a substantial market for shorter-term municipal obligations, the rather limited market for long-term tax-exempts is rapidly becoming saturated. For the record-

breaking volume of municipal obligations to be marketed successfully, they will have to offer yields that will appeal to investors to whom tax exemption is not a prime consideration.

In the course of the readjustment in bond prices, the abnormally narrow differentials between yields on variously graded corporate bonds and governments have widened. The average yield on seasoned corporate bonds of the highest grade, those rated Aaa by Moody's Investors Service, at the current level of 2.72 per cent, is 0.41 per cent above the 2.31 per cent average yield on long-term Treasury bonds. As recently as July, the differential ran no more than 0.30 per cent. As the accompanying chart and table bring out, the widening of differentials between yields on Baa rated bonds and the long-term Treasuries has been even more marked.

Yields on Selected Long-Term Securities

	June 30 1945	June 30 1946	June 30 1947	Sept. 30 1947	Oct. 31 1947
High grade pref. stocks*	3.66%	3.46%	3.75%	3.79%	3.96%
Baa corporate bonds†	3.29	3.03	3.21	3.30	3.40
Aaa corporate bonds†	2.61	2.49	2.55	2.67	2.72
High grade municipals*	1.58	1.55	1.92	1.96	2.08
Treasury bonds 15 years or more to maturity or nearest call date	2.33	2.16	2.25	2.24	2.31

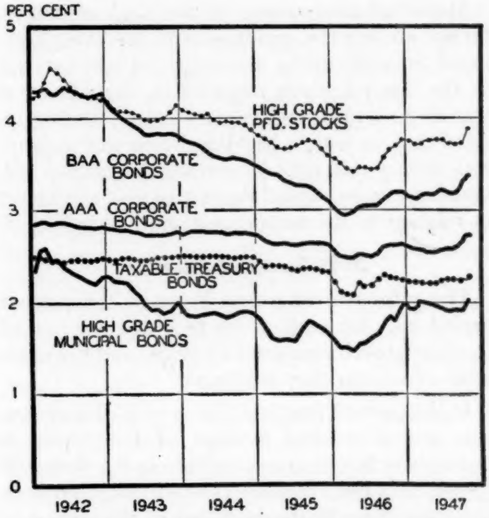
Sources: *Standard & Poor's Corporation. †Moody's Investors Service.

The widening of the differentials reflects the end of a sellers' market, in which institutional investors such as insurance companies and pension funds paid record prices for top-grade corporate obligations in order to put their fresh accumulations of investment funds to work. At the same time, with the substantial additions to the indebtedness of corporations and the conversion of some of their wartime accumulations of cash and government securities into higher-priced inventories and costly additions to plant facilities, investment institutions are becoming more cognizant of risk elements and are insisting on yields large enough to permit adequate appropriations from income to reserves against possible losses.

Are There Enough Savings?

The question has been raised as to the adequacy of the supply of current savings to meet the unexpectedly large demands for long-term capital. The recent demands come not alone from the corporations, and State and local governments, but also from home-builders, and from the Federal Government through the sale of Savings bond type obligations for the purpose of shifting more of the government debt out of the banks.

Data compiled for many years by the Commercial and Financial Chronicle, covering security issues for raising new capital by domestic corporations, State and municipal governments,



Average yields on High-Grade Preferred Stocks, Corporate Bonds, Municipal Bonds, and Long Term Treasury Bonds. Monthly plottings 1942-1946; weekly plottings 1947 through October 24. Sources: Corporate bonds – Moody's Investors Service; Preferred stocks and Municipal bonds – Standard & Poor's Corporation; Treasury bonds – U. S. Treasury average for issues over 15 years to maturity or nearest call date.

and foreign governments and corporations, suggest that the volume of new money being sought through these channels should be well within the absorptive capacity of the investment markets. The following table, drawn from the Chronicle's tabulations, shows that during the period of fairly stable prosperity from 1922-27, on a national income level no more than three-eighths that of today, corporations raised new capital through issues of stocks and bonds at an annual rate of $3.3 billion. Such issues during the first nine months of 1947 ran at an annual rate of $3.5 billion. The biggest increase shows up in State and municipal offerings, but the foreign item is smaller and the total is running no more than about $1 billion, or one-sixth, greater than in 1922-27.

New Security Issues for Purposes of Raising New Capital
(In Billions of Dollars)

	Annual Average 1922-1927	1946	Jan. - Sept. 1947 Converted Annual Rate
Domestic			
Corporate			
Bonds and notes	2.3	2.0	2.5
Preferred stock	0.5	0.8	0.6
Common stock	0.5	0.7	0.4
Total, Domestic Corporate	3.3	3.5	3.5
Federal agencies	0.2	0.1	0.3
State & municipal	1.3	1.0	2.5
Total, Domestic	4.8	4.6	6.3
Foreign	0.9	—	0.4*
Total, New Capital	5.7	4.6	6.7

*Includes International Bank for Reconstruction and Development.

Source: Commercial and Financial Chronicle except for final column which was computed from the Chronicle's tabulations.

Statistical comparisons of this kind, of course, do not answer the question as to the overall demand for new capital, the supply of new savings, or the interest levels required to bring the two into a balanced relationship. Yet, bearing in mind that, as now, a building boom was in progress during the 1922-27 period, the current demands for new capital do not appear exorbitant in relation to the current national income level.

Deficiency of Savings

The principal difference between the present period and the earlier one is in the sources of funds to absorb new security issues and the character of savings they represent.

In the present juncture, the supply of new savings out of current incomes of individuals is seriously deficient in relationship to the demands for capital. For example, the individual investor has come close to disappearing as the source of new capital for private business. Estimates of the Securities and Exchange Commission indicate that individuals in all of 1946 added nothing, net, to their holdings of corporate stocks and bonds. The same is true for the first half of 1947. A major cause is income tax levels so high as to force continuous dissaving in the higher income brackets and shut down new supplies of saving farther down the line.

The individual savings that take place today in largest volumes are either institutionalized savings, reflected in accumulations of insurance and pension funds, or savings in anticipation of consumption. These funds are not available for equity investments in common stocks. The absence of substantial individual savings for taking risks of ownership is a serious missing link in the structure of sound financing of postwar prosperity. Without them, the pressure is on the corporation to sell bonds and to go further into debt to the banks and to the institutional investor. This has been the cheapest and easiest way of raising new funds. Often it has been the only practicable way.

Rapidly accumulating debt is both a cause and a consequence of the inflationary pressures, for in a wage-price spiral, business constantly needs more and more money to keep going and this leads to the incurrence of more and more debt by business and more and more spending by the individual. To check this kind of spiralling — which is to the ultimate benefit of no one and to the injury of all — is not simple.

One way of preventing bank credit expansion from aggravating the inflationary pressure is to make possible more equity financing with individual investors. Here changes are imperative in the tax laws that not only cut off new supplies of risk capital but place all the odds in favor of borrowing rather than selling stock to raise new capital. The corporation can charge interest payments off as a business expense in calculating its income tax liability. On the other hand, earnings from new capital raised by selling stock are taxed whether retained in the business or paid out as dividends. In the latter case the earnings get taxed again as the stockholder pays his personal income tax on the dividends.

Another way is to make credit dearer and discourage capital expenditures at the source — by business for plant and equipment, and by government for public works.

Short-Term Rates

The responsible authorities have been moving, gently but firmly, in the direction of firmer money, by attempting to mop up some of the overabundance of loanable funds in the hands of the banks. The problem is complicated by the influx of gold, at a current rate of around $3 billion a year, which tends to replenish the excess reserves of the banks as fast as they are used.

In July, the authorities began a series of moves which, carried far enough, could restore to the Federal Reserve System control over the supply of bank reserves. The first steps were to double the ⅜ per cent rate on Treasury bills, which had become far out of line with the general structure of short-term interest rates, and subsequently to allow the average yield on the new offerings to rise about one-hundredth of one per cent a week. On the 91-day Treasury bills sold October 30 the average rate was up to 0.87 per cent.

The rate on certificates meanwhile has been raised from ⅞ per cent on the one-year issue of July 1 to 1 per cent on the eleven months issue of November 1. The official support points for old ⅞ per cent certificates have been adjusted downwards with the result that the issues coming due in July are currently available from dealers at a discount of twenty-five cents per $1,000 to yield 0.91 per cent.

Yields on Selected Shorter-Term Government Securities

	June 30 1945	June 30 1946	June 30 1947	Sept. 30 1947	Oct. 30 1947
3 months Treasury bills	0.375%	0.375%	0.375%	0.82%	0.87%
6 months certificates	.78	.83	.84	.83	.83*
9 months certificates	.80	.83	.88	.87	.91†
June 1948 1¾s	1.13	.99	.94	.94	.93
September 1950-52 2s	—	1.15	1.26	1.24	1.37

*5 months. †8 months.

From the fact that the Federal Reserve Banks added $190 million net to their holdings of short-term government securities between June 25 and

October 22, the conclusion is suggested that the "defrosting" policy is not yet achieving its ends. The same conclusion could be drawn from the fact that the banks continued to bid for government bonds more or less throughout the period of initial "defrosting" and have been expanding their loan portfolios steadily. Yet it is fairly evident that, while the gap between short and long rates has not been cut down very materially, the possibility that the authorities will continue to draw back their support levels and allow short-term interest rates to rise further has entered into bankers' calculations and provided an inducement to continued holdings of short-term Governments in anticipation of a further improvement in short-term yields. Some hardening has been apparent in loan rates and banks are less eager to enter into term loan arrangements.

In the dynamic situation with which the authorities are currently confronted, it is necessary for the Federal Open Market Committee to keep backing away on its supporting operations simply to avoid adding to bank funds available for lending or investing.

Lessons from Abroad

While the maintenance of orderly markets for government securities is naturally a matter of concern to national Treasuries, central banks, and the investing public, efforts to maintain a rigid stability, or to drive interest rates down, during a period of inflationary boom, aggravate inflationary pressures. This seems to be the moral to be drawn from the suspension of British efforts a year ago to drive the rate on long-term government borrowings down from 3 to 2½ per cent during a period in which, partly by reason of this attempt, the money supply was being inflated even more rapidly than in the war years. British 2½ per cent consols sold for par in October, 1946, slid off to as low as 80¼ in August of this year and are currently quoted at about 88½. Available information does not make it possible to assess how far the recent recovery is the result of public buying attracted by the higher return, official "management," covering by short-sellers, or speculative purchases induced by indications that the drive for a 2½ per cent rate may be revived.

In Sweden, the government central bank has been maintaining a fixed support for 3 per cent bonds at a time when the country's gold and foreign exchange resources were being rapidly drained away to finance large import surpluses. Thus the tendency for import surpluses to draw off excessive purchasing power has been neutralized in major part by the shift to the central bank of public debt previously held by the banks and the general public. The inflation problem remains on hand. To meet the crisis, the Swedish Government has invoked a series of direct controls, including a severe cutback in building activity, tightened limitations on imports, and seizure of all private holdings of dollars, Swiss francs, Argentine pesos, and Portuguese escudos of Swedish nationals plus certain other assets in those countries.

The experience of the occupied countries suggests that when governments try to borrow money at rates too low to attract genuine savings, or to compete with alternative outlets for funds, the government bonds they sell wind up in the central bank which pays for the bonds by issuing new notes or by giving banks credits to their reserve accounts on its books. The end result is a dressed up version of old-fashioned printing press inflation. In fact the results can be worse if the doors of the central banks are held open to the "monetization" not alone of current government deficits, but also of government securities originally taken up by the public in financing previous government deficits. It is little wonder that in so many countries respect for the money of the realm has descended to such low levels.

Some Conclusions

The task of the American authorities is by no means easy. A balanced budget, with a surplus available for retirement of bank held debt — which we have — is a necessary condition to the avoidance, in the present-day environment, of the more exaggerated forms of inflation that are to be witnessed in so many other countries. The public itself, the banks and other investment institutions, have demonstrated self-restraint to a degree that is remarkable under the circumstances. Our Achilles heel lies in excessive reliance on the banks, and on the institutional investor, for funds that ought to be provided through equity financing. Viewed in this light, the upward readjustment in the cost of long-term borrowings, and the adoption by the authorities of policies calculated to discourage shifting of government securities to the Federal Reserve Banks, are moves in the right direction.